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BANKING DEREGULATION AND THE BANKING INDUSTRY

Moderator: JOHN K. BOOTH. Panelists: GARY E. HUGHES, JOHN H. KALCHBRENNER**, MICHAEL L. KERLEY***. Recorder: THOMAS E. RHODES*

Banks and savings and loans have been moving into the insurance business. Bills and regulations have been proposed which will allow banks to directly compete with insurance companies. Discussion topics will include:

- Bank Holding Company Act
- Status of deregulation proposals
- Comparison of banking products with insurance products
- Comparison of bank and insurance company distribution system
- The comsumers' view of banks vs. insurance companies
- How banks currently market insurance products

MR. JOHN K. BOOTH: In recent years, banks, as well as insurance companies, have seen their profits eroded by inflation-driven overhead costs and by customer disintermediation in response to higher interest rates available elsewhere. The banks have responded by introducing new technology to increase their efficiency in making and marketing their products and services and by seeking removal of the regulatory barriers that prevent them from providing to the public an expanded base of new financial products and services. In the latter area, we have seen initiatives in the Congress, in the Administration and at the State level which would broaden banks' powers to engage in other financial activities including insurance. There also appears to be some interest on the part of a few financial institutions in acquiring banks.

As the banks move into the marketing of insurance, they will enjoy frequent repetitive contacts with their customers that life insurance agents do not have, particularly if they are able to offer other financial services such as brokering a customer's securities portfolio. The information gathered by banks from monitoring their customers' use of bank credit cards, use of lines of credit, trading in securities, and other financial transactions could be used to build profiles of individuals and of families to identify those customers who have insurance needs and should be solicited for insurance by the bank and its employees.

* Mr. Hughes, not a member of the Society, is Chief Counsel of The American Council of Life Insurance.

** Mr. Kalchbrenner, not a member of the Society, is Senior Vice President and Chief Economist of the Shawmut Bank of Boston.

*** Mr. Kerley, not a member of the Society, is Vice President, Government Affairs of the National Association of Life Underwriters.

Would this be a more effective and efficient way to distribute life insurance products than prospecting by a life insurance company agency force? Are we likely to see cooperative ventures between insurance companies and banks where a life insurance company makes and designs products and a bank markets them? Will the spread of home banking and handling of financial services through interactive communications networks cut out the life insurance agent?

In the quest by financial institutions to trim costs and to beat their competitors, are we likely to see discount banks and discount insurers offering only the most basic products and services?

To address these and other questions, I will ask Gary Hughes to tell us what has been happening at the Federal and State level, with respect to banking deregulation.

MR. GARY E. HUGHES: I think that the continuing debate over reshaping the concept of the Nation's financial institutions, is, from an intellectual standpoint, a very challenging and fascinating endeavor. It is complete with high drama, very strongly expressed views, and sometimes good theatre. The challenge is due in large part to the fact that you have a situation where all the major players in the game are involved, and the stakes are extremely high. If you listen to some, it sounds as though the fate of entire industries hangs in the balance on the issues that are being discussed. To some extent that may, in fact, be true.

The issue of integrating banking and insurance has come center stage recently. We have heard for some years of the efforts of banks to get into the securities business to a greater extent than they are. But insurance seems to be on the front burner, at least at this point in time. Like the other issues here, the integration of banking and insurance is an important issue, the stakes are high, the views are strongly expressed by all sides. There are often conflicting views and I think from this mornings' discussion, you should get some sense of the divergence of opinion on this issue.

What I would like to do to set the tone for the panel is to give you a brief overview of what laws are in place now. These laws, at least to some extent, keep banks on one side of the line and other commercial endeavors on the other side of the line. Then, I will discuss the legislation that we have seen in the last year, right up until present, and mention very briefly what some of the regulators are doing in this same area.

The main law that keeps commercial banking separate from investment banking, insurance, real estate and other commercial endeavors is the Banking Act of 1933. It was enacted largely as a result of the stock market crash of 1929. You hear bankers say it was an over-reaction to 1929. In fact, I read recently that the President's Council of Economic Advisors suggests, in its latest report to the President, that the collapse was caused by the Federal Reserve Bank's (Fed) monetary policy in that the Fed did not come to the aid of the banks when it should have with all of the resources that it should have.

So you have under the Banking Act of 1933, as reinforced by the Bank Holding Company Act, the basic separation between commercial banking on the one side and on the other side securities underwriting, insurance, and real estate. It sounds simple, but as years have gone on, it has become very complicated. The complexity is due, perhaps, to poor draftsmanship of the laws, litigation and interpretation by the agencies. It may be helpful to run through, at least on securities and insurance, several over-simplified examples of how the distinction has already been blurred.

As far as bank involvement on the securities side, and when I say "bank" I am really referring to depository institutions generally, banks have always been able to act as agents for their customers in the execution of securities transactions, that is, in an agency capacity. This brokerage agency function, as opposed to the underwriting function, does not involve general underwriting of securities. But that function is what has given rise to the current phenomenoma of banks buying discount brokerage houses and running a full discount brokerage service. Secondly, banks have been permitted to underwrite general obligation bonds. Banks also engage in the pension business and their corporate qualified pension business is subject to the anti-fraud provisions of the Securities Laws. So that is another example of securities activity.

I think it is a little more complicated when you get to insurance. For over a decade, banks have been in the business of marketing credit life insurance and credit accident health insurance. Many banks have insurance agency subsidiaries today. Three states have authorized banks to underwrite savings bank life insurance. More recently we've seen a number of arrangements whereby insurance companies and banks, while not getting into a subsidiary or affiliate relationship, have put together deals. For example, the insurance company packages the product, takes it to the bank or savings and loan, and arranges for the depository institution to market the product. The particular format of those arrangements varies greatly. In some cases, the bank employee is both an employee of the bank and a licensed insurance agent. In other cases, the individual in the bank is not an employee of the bank but is an employee of the insurance company, that is, the insurance company has simply put one of its agents in that bank. In other cases it doesn't appear that an insurance agent is involved at all, although at some point along the line an insurance agent would process an application for the purchase of insurance.

Thrift institutions present a slightly different situation in that there has been a law on the books for some years which creates the creature known as a 'diversified Savings and Loan (S&L) holding company.' This is an arrangement whereby a non-banking institution can acquire one savings and loan association, provided certain other size requirements are satisfied. This is the provision in the law which gives rise, for example, to the Sears complex where under one corporate umbrella you have Sears, Allstate Insurance, and Allstate S&L. The same thrift institutions through their service corporations have for some years been authorized to engage in a wide variety of insurance agency activity.

Notwithstanding the somewhat limited ability of banks to get into both securities and insurance, there has been a major push by the banking lobby

to expand the power of all depository institutions in these areas. I would like to touch on a couple of the proposals which I think will set the stage for what is to come later on the panel.

The first proposal is generally referred to as the Treasury Proposal. This proposal, that the Treasury Department developed in conjunction with banking interests, reflects a view of the Reagan Administration that institutions such as banks should be deregulated. They should be permitted to engage in all facets of commerce, specifically insurance, securities and real estate.

Structurally the proposal would do the following: If a bank wants to get into the insurance business, it could do so if it set up an up-stream parent holding company and that parent established a down-stream subsidiary insurance company. That would make the bank and the insurance company affiliates and there would be no direct parent/subsidiary relationship between the two. The theory here is that by separating the bank and its non-banking endeavor through this mechanism you safeguard the solvency of the bank from the insolvency of the non-bank endeavor. Also, it is hoped that you would avoid the problem of conflicts of interest and certain financial dealing between the two which could have an adverse effect on the banking system as well as an adverse effect on the related insurance operation or securities or real estate operation.

There are views expressed in both the insurance camp and the banking camp that this is not a particularly good arrangement. Some of the banks feel that is a very expensive and unnecessary way to do business. Perhaps a bank simply ought to be permitted to run an insurance company as a direct down-stream subsidiary. On the insurance side and the securities side, there is concern that even if you go through all the moves of setting up a parent and a down-stream subsidiary you have not isolated the bank from its non-bank activity. Perhaps such an arrangement does, in fact, present a threat to the solvency of the bank and to the solidity of the banking system.

On a more parochial note, mutual insurance companies have a difficult time with the Treasury Proposal because, as mutual companies, they could not set up an upstream parent holding company. Apparently under the Treasury's scenario, they would not be able to play the game of reciprocally getting into the banking business at all. We have not found much sympathy on this point at the Treasury Department. They shrug their shoulders and say "well, that is a matter of state law, perhaps all your mutual insurance companies should consider de-mutalization." I think we found this a rather unacceptable solution to that problem.

Notwithstanding the great debate on the Treasury Proposal during of 1982, the major banking legislation which passed at the end of last year, the Garn-St Germain Depository Institutions Act of 1982 (Garn-St Germain), did not expand bank powers in the securities and insurance areas. It was silent on securities. On the insurance side, due almost entirely to the efforts of insurance agents, there was a section of that bill which severely limited the ability of bank holding companies and their non-bank subsidiaries to get into the insurance business. It could be said that what that provision does is maintain the status quo. It maintains the level of bank insurance activity that existed at the time that the legislation was passed.

Significantly it also took away from the Federal Reserve Board its discretion to consider on a case by case basis applications that a bank might make to engage in additional insurance activity. It does stand for the proposition generally that insurance is not closely related to banking except in several very narrow areas.

Garn-St Germain empowered thrift institutions to engage in certain commercial transactions and, in many respects, they look very much now like commercial banks. In addition, there was a very significant provision which authorized all depository institutions to establish money market deposit accounts. This was based in large part on the fear of the banks that without some legislation the continuing ability of the mutual fund industry to go after the savings dollar was going to disintermediate deposits from banks. It was presenting a serious problem for most of 1982. The banks were pushing for money market fund powers and the ability to underwrite, say, their own family of mutual funds. What ultimately came about may have been the best of both worlds. They got the money market deposit account, which is an excellent product because it is not tied to money market rates. As the investment company institute said, you can use predatory pricing practicing by subsidizing a high rate for a very short period of time in order to attract deposits and then drop the rate down shortly thereafter. They have been certainly highly successful. They have federal insurance which the mutual funds do not have. They are not regulated by the Securities and Exchange Commission as the mutual funds are. So it is a very interesting and very useful product from the bankers' standpoint.

Backing up, what the Garn-St Germain Act did was say that bank holding companies and their non-bank subsidiaries were generally left out of the business of insurance except for several limited circumstances.

I think the insurance industry, for a moment, breathed a sigh of relief and said 'well that puts that one to bed for awhile.' But that was not the case. The banks became very inventive and creative and searched for a way around Garn-St Germain to get further into the insurance business. They found what I would describe as a "live one" in the use of enabling state legislation as a vehicle to side step the Bank Holding Company Act. The proposition has not been tested yet and it is an interesting development.

Let me give you a brief explanation of how the banks would hope this proposition would work. Legislation recently passed in South Dakota defines the business of banking to include all facets of the business of insurance for South Dakota chartered banks that are not members of the Federal Reserve System. Citicorp has announced its plans to buy a South Dakota bank invested with these insurance powers. It will then file an application with the Federal Reserve Board for the acquisition of that bank. The Federal Reserve Board has one of two ways of looking at this. The first way, and the way that I think Citicorp is counting on, is that they will say that as long as the bank is duly chartered and its powers reflect its charter, we are not going to look into the doors of the bank to see what it is doing. And as long as insurance, at least in South Dakota, is defined as the business of banking, the Fed need not inquire further and all other things being in order, we will approve the application.

The flip side of the coin that the insurance industry is counting on holds that the Fed will say that it cannot ignore this scheme which perhaps is to avoid the prohibitions of the Bank Holding Company Act. That Act applies to bank holding companies and to their non-bank subsidiaries. In this case, Citicorp would be acquiring a bank, and the narrow reading of the law is that the prohibitions on banking insurance activities that are contained in the Bank Holding Company Act would simply not apply. But if the Fed views this as in fact the circumvention of a Congressional statement reflected in Garn-St Germain and a circumvention of the entire purpose of the Bank Holding Company Act, perhaps they may not be inclined to grant that application.

There was a very recent development that we can discuss in some detail a little later. Senator Garn, as Chairman of the Senate Banking Committee, had the first day of oversight hearings yesterday on the subject of integrating financial services. The one witness yesterday was Donald Regan, Secretary of the Treasury. I heard that he said very forcefully that the South Dakota-type legislation was inappropriate and there should be Federal legislation that prohibits it because it really is anathema to the Administration's deregulating proposal. I think there is now a fairly high likelihood that there may be legislation introduced that would eliminate the South Dakota-type situation. South Dakota-type legislation is also being considered in several other states, most notably Delaware and Maine.

I have mentioned some of the efforts of banks to get into the insurance business. The converse is also true, although I am not sure to the same extent. As I mentioned there are entities called diversified S&L holding companies whereby an insurance company can directly own at least one savings and loan association. Post Garn-St Germain, savings and loans may be viewed as the functional equivalent of commercial banks. If it is wrong for insurance companies and banks to be together, I think at least the insurance industry is presented with a very difficult problem. That is, whether or not it is right for the diversified S&L holding company to exist.

Another area where the banks would say that the insurance companies have entered their business is with money market mutual funds with check writing privileges. There is certainly an open debate as to whether a money market fund with check writing privileges is that close to a demand deposit or whether the check writing privilege is simply a handy mechanism for redemption. But the bankers and many people in Congress do feel that that is an example of insurance companies and others moving directly into the banking business.

The last thing I would like to mention here is the phenomenon known as non-bank banks. They also go under the name of consumer banks or near banks. Under the Bank Holding Company Act, a bank is defined as an entity that takes demand deposits and makes commercial loans. What a number of non-banking entities, such as Dreyfuss, Parker Pen, and Gulf and Western, have done is to apply to acquire a bank that either does not take deposits or ceases its commerical loan activity. Technically, therefore, that entity, whatever it is, does not fit the literal definition of "bank" in the Bank Holding Company Act. I believe about 10 applications for non-banking enterprises to acquire a non-bank bank have already been granted.

Recently, the Comptroller of the Currency made an announcement (and this seems to be somewhat orchestrated with the position of Don Regan of the Treasury) that there will be a moratorium until the first of the year on any more applications for the acquisition of non-bank banks. We believe that the Fed, in the meantime, is actively drafting legislation that would permanently close what the Fed perceives to be a very serious loophole.

I am not sure that any insurance companies have applications pending involving non-bank banks. However, many of you may have seen the announcement by Prudential that they are interested in such an acquisition. The moratorium would not affect anyone with an application into the controller now. If an application is already filed, presumably it can be processed. But any new applications would not be considered until the first of the year.

I think that gives you a general overview of some of the law, the regulation, and the legislation that is part of this debate.

MR. BOOTH: In his keynote address this morning, Jack Miller said there must be something good about our business or the banks would not be trying to get into it. Our next speaker, Jack Kalchbrenner will give us some insight as to "Why are the banks trying to get into the life insurance business, and is this going to be beneficial to the public?"

MR. JOHN H. KALCHBRENNER: What I would like to talk about this morning is the way we have seen the situation generally developing over the last decade, the reasons for going into insurance and three important developments in public policy concerning banking.

The head of our community banking group has a favorite expression that he picked up from a consultant somewhere: "Banking will survive but the banks may not." That is the kind of defensive posture that we view ourselves as being in. I should mention that there is competition among different sizes of banks. For example, Shawmut Bank is a regional holding company based in Massachusetts. Throughout the state we have 11 separate banks, each with its own Board of Directors and set of officers, and a total of some 175 or so branches around the state. Though we are not in the same position as far as geographical coverage as Citibank and others, we are in a position of trying to react to the same kinds of pressures that smaller banks are feeling, including pressure from the money center banks as deregulation proceeds. (And I will get back to that in just a moment.)

Banks, as everybody knows, formerly lived in a rather well-protected world. There were geographic constrains on competition from other banking institutions, and very close scrutiny by the regulatory authorities when you wanted to do anything that involves expansion or market competition tests.

Banks controlled the payments mechanism. Because of Regulation Q interest ceilings and deposit insurance, banks were pretty much guaranteed low cost funds from both the business sector and the general public in order to conduct their business. They were the principal intermediaries between the ultimate savers and the economy. The savings flowed in from the income stream and then were passed to the credit markets through a series of steps. Because of protection, profitability was not high in the banking

industry. It was not a fast growing industry even with the "go-go" sixties period when the leverage of banks went up so much. This began to break down over the last decade. We could see it at the Federal Reserve when the monetarist forecasting techniques that we were using, along with the other techniques at the Federal Reserve, started to break down. A related breakdown occurred with corporate cash management in all of the steps taken to minimize cash balances of various types due to inflation. So it was obvious that problems were coming for both the banking system and for the regulatory structure that we had. But because things were changing so quickly, it was rather difficult for the regulatory authorities to move.

The rise in popularity of governmental deregulation is only one strand of what has happened over the past decade. We have seen deregulation of the securities industry, transportation, communication and also knowledge in financial services. But that is only one part of it. I think the driving force in the financial services industry was even more importantly related to the inflationary period that we have been through.

There was a change in public policy when it became apparent in the 1970's that inflation was getting out of hand. There was a shift away from the multiple objectives that were used by the regulatory authorities. These objectives protected thrifts and banks from bearing the full brunt of anti-inflationary actions over a long period of time. This regulatory trend, the continuing inflation and the amount of time required to reduce inflation led to a host of opportunities for others to come in and do banking functions. This is because the banks and the thrift industry could not follow the market due to Regulation Q and the kind of portfolios that they held. Rising inflation in the U.S. sharply increased the costs of adherence to the interest rate ceilings imposed under Regulation Q. The increasing spreads between market interest rates (which reflected the inflation and policy efforts concerning inflation) and regulated deposit rates provided a growing incentive to devise means of circumventing the controls. Cash management, repurchase agreements, remote disbursing and the rise of the money market mutual funds are all examples of the results of these incentives.

The banks and S&L's both lost a share in terms of control over the total financial assets of the nation. Depending upon whose numbers you look at, the worst kind of a loss was from 60% to between 35-40%, but I do not really think those are relevant numbers to be using. I think there was a 5% share loss in this period for the commercial banks in particular.

The regulatory system that had provided the base for banking for many years became obsolete and unworkable because of events over the last 10 years. Deregulation, whether it was popular or not, became a necessity. There had to be a great deal of re-thinking of just what it was that regulatory authorities were trying to do in terms of protecting the payments mechanism and conducting a monetary policy that would be in the best interest of the nation. And the main question becomes one of what is the best way to accomplish the deregulation that was going on anyway.

From the banking standpoint, there were a number of other trends in banking that bankers look at very strongly internally. Over the past decade, the regional banks, and to an increasing extent even the money center banks, began to lose the national loan market. This market was the principal bread

and butter market that many banks were in for many years. The national loan market and international loan market became increasingly less profitable. Beginning in the early 70's, large foreign banks began to enter the United States markets with direct presence. They were extremely aggressive in their competition in shaving the spreads down. They came into the regional areas with loan production offices and other techniques. They began to come in and push down the spreads in the regional market. And increasingly those of us in the regional markets have been pushed down into the small business market where we do have advantages of knowing the market very clearly and having the opportunity to know the individuals that are involved. This approach to small markets is very difficult for large banks that must keep their costs down.

A bank the size of Shawmut has its main market in the small business area. We are down from the middle market, we are moving away from the large market, the international market and the large national market. Part and parcel of the loss in spreads in the national market was the increasing amount of activity by corporation treasurers and others to do direct lending through the commercial paper market or other arrangements. That also made it difficult for some of the large money center banks to stay in that market.

This matched the deregulation that has been going on. Both the defacto and the actual legal changes that have been made have left the banking system with an obsolete operating structure. Because of Regulation Q, we wound up with widely distributed branches that gather deposits on the basis on non-price competition (plush quarters to bring people into, pots and pans promotions). This non-price competition was perhaps suitable for the earlier era but is now dead weight cost in the current environment. We are very heavily involved in working to reduce costs. At the same time, we are very heavily involved in very substantial capital expenditure costs in order to make these reductions possible while still being able to access the depository base of our customers within our service region.

So there is a strain on capital throughout the banking industry. With a large branch system, it is hard to re-configure it and make it partly a service organization and partly an electronic operation. There are many more costs involved in data processing now then there had been in the past. There are also a strong drains on the capital positions of the banks that are involved in this configuration.

Part of the result of this erosion of loan spreads has been an increasing interest in generating fee income. This is a significant factor behind the interest in going into insurance. Although some banks, such as Citicorp and Bank of America, are interested in getting a rationalization of the whole regulatory structure. In looking at the attractiveness of going into insurance, the underwriting aspect of it does not look terribly attractive to any, except possibly the very largest banks in the country. It is a high cost operation to get into and to develop the expertise, which is absolutely essential to be successful in that business. Banks certainly do not have any actuaries on board at this point that would allow them to go into the business quickly. They are stretched with respect to their capital positions in other directions in order to maintain their standard forms of

business. But the brokerage activities, whether in tandem with an insurance company or independently, do look more attractive.

We have a grandfather insurance agency within our holding company. We are certainly not running around introducing new products on a daily basis. We have enough problem keeping our main business, sticking to our knitting as it were. Although clearly we will probably use that agency in the not too distant future, it is also important to bear in mind that there are tremendous differences among banks. Banks fight banks internally, banks fight the thrift industry. There has been the traditional battle that has been going on and is still going on. There are substantially different interests between the large multi-national banks and the small banks that will color any of the changes that we will see as we go along. For the most part, most of the 14,000 banks across the country are quite fearful and view the things that they are doing as defensive in nature. Many of the small bankers would very much like to go back to the world the way it was, but they cannot. The changes are underway, they are not going to disappear, and we cannot stick our heads in the sand or you will not be there. Banking will survive, but the banks may not is the watch word there.

Finally, banks, insurance companies and other institutions that make up the financial services industry should pay close attention to three important developments in public policy. The first is the reintroduction of the administration bill concerning the separation of commercial banking and bank holding company activities. The second is the early stages of a review of the meaning of "banking" within the Federal Reserve System as represented by the essay in the annual report of the Federal Reserve Bank of Minneapolis by its President, Gerald Corrigan. Finally, over the last few years there have been several proposals for revising the entire financial regulatory structure coming from the Congress and the current regulatory agencies.

There is a danger that banks and other financial services institutions could become enmeshed in a repeat of the same type of futile dispute that has existed between banks and other thrift institutions for a long period. The likelihood that this might occur would be enhanced by focussing on the "laundry list" approach to regulation that has been followed by the Federal Reserve in past year. In the meantime, the entire regulatory structure might be altered without adequate comment from the institutions most directly affected. Given that the clock cannot be turned back, active involvement by all participants in the financial services industry will be necessary if the current helter-skelter financial regulatory system is to be rationalized.

MR. BOOTH: It is interesting to note how similar some of the problems facing the banking industry are to those facing the insurance industry. Mike Kerley will now give us the life insurance agents' view of banking deregulation.

MR. MICHAEL L. KERLEY: The National Association of Life Underwriters (NALU), which I represent, does not pretend to know that any individual or company or financial industry trade association can predict where the trend towards deregulation of financial institutions is going to lead. Certainly there is every indication that some companies are willing and lawfully able

to offer a diverse range of financial products under one corporate shell and even literally under one roof.

Whether so-called financial supermarkets will ultimately be in the best interests of the nation and consumers in general, or will prove to be economically profitable for the companies that are engaging in the efforts, are questions which really have uncertain answers. But it would appear that while there are many unanswered questions, many organizations will test the waters to see where it goes.

While NALU cannot predict what financial supermarkets of the future are going to look like, we do have a general philosophy, one that has been on the books of NALU since around 1968 that states our opinion on how financial supermarkets should be structured and regulated. Basically, NALU does not believe that insurance products should be sold by depository institutions which engage in commercial or consumer lending activities. Our concerns are founded on the dangers which such arrangements portend in the way of decreased or unfair competition. These arrangements lead to conflicts of interest and possibly even the undue concentration of financial resources, which means simply that one financial entity is going to wind up with all the money in the country.

Basically, the NALU believes that financial institutions which extend credit to the general public, such as commercial banks, are ominously positioned in the financial sector of the economy because of the tremendous power which the credit-granting function provides. Through this unique power to grant credit, banks and their affiliates are in a position to exert unfair influence over would-be credit customers in cases where the decision whether to purchase additional services or products from the bank or elsewhere is involved.

I can tell you of some personal experiences in this matter. I was in the banking business for 5 years. I was a lowly trainee just out of college and training in a branch office. An insurance agent came into the bank to apply for a small unsecured loan. We talked about credit life insurance, which typically we tried to tack onto any personal loan, and I realized that we were in a position to sell insurance. So I went to the manager of the branch and I explained to him my great idea about our possibly getting into the insurance business. He informed me that I was not the only one who ever had this idea. In fact, he had this idea himself. So he investigated the possibilities and found that the State of Maryland prohibited bank employees from being licensed. He explained to me that what I was talking about, mainly the ability to apply that credit lever to the extension of insurance or the purchase of insurance, was what prompted the Maryland Insurance Department to prohibit bank employees from being licensed as insurance agents.

So it became very clear to me, very early in my business career, that it was quite easy to combine the function of lending with the function of marketing insurance. In one way or another, I have been involved with that issue ever since. I never realized that I would be at it this long.

The staff of the Comptroller of the Currency, using figures developed by the Federal Reserve Board staff, found that something like 36% of all debtors purchasing credit life insurance felt that the purchase of this insurance was either strongly recommended or required in order to get a loan. Given this statistic, together with the Federal Trade Commission report that penetration rates on the granting of credit life insurance sales to customers by finance companies is something in the 90% range, NALU believes that there is persuasive evidence that lenders should, in most instances, be affirmatively precluded from marketing insurance to their customers. NALU's concerns and indeed most of their position was incorporated into legislation adopted last year, which Gary Hughes had mentioned, the Garn-St Germain Depository Institutions Act. A section of that act amended the Federal Bank Holding Company Act to specifically prohibit bank holding companies and their subsidiaries from providing most kinds of insurance as principal agents or brokers, subject to a few exceptions.

We are concerned with what we hear about banks' foreign lending operations, particularly the large banks, and their threats to solvency of the individual banks as well as to the overall banking system. Although much has been written recently about the overall lending activities of large U.S. money center banks, it is perhaps constructive to look at a recent popular article on this issue.

There was a recent Time magazine article which chronicles the enormity of the financial risk engendered from overseas lending by these banks. As noted in the Time article, and let me quote, "Nine of the largest U.S. banks have loaned about 130% of their equity to Mexico, Brazil and Argentina." These loans are in serious jeopardy, as you all know from reading the Wall Street Journal. Apparently these loans were generated, once again from the NALU perspective, with an emphasis upon maximizing rates of return to the exclusion of prudent lending practices and perhaps with a disregard even for this country's own capital needs. I'm certain that that view is probably not shared by most bankers. Many bankers perceive that these loans were made, with the blessing of the Federal Government or at its insistence, to some of these countries in order to insure the energy sources to our country.

The business of underwriting and marketing insurance is a very sophisticated and complex undertaking, requiring special expertise. We think that banking institutions should be encouraged to combine their energies towards enhanced performance of their own specialized areas rather that attempting to offset lending losses by generating additional income with the fee income that Jack Kalchbrenner just mentioned.

Some banks will continue to press for action, in state governments and elsewhere, in an effort to sidestep Federal legislation such as Garn-St. Germain. We are very dismayed by the recent legislation enacted in South Dakota which will permit out of state holding companies to purchase a South Dakota State Bank which could, in turn, underwrite and sell all types of insurance. We view this legislation as undesirable not only from the unfair competition standpoint, but for several other reasons as well.

First, from a political standpoint, that legislation was originated and passed in a very short period of time with very little, if any, opportunity for hearing or airing of views. It looked like there was a very good pre-legislative job done on educating the governor and the state legislature on why this legislation should be adopted. Parties with supplemental points of view were pretty much foreclosed from the opportunity to be part of the legislative process.

But more importantly, little, if any, guidance is given in the legislation as to how a South Dakota State Bank/Insurance Company combined operation is going to be regulated under state banking and insurance laws. This issue is essential to the state regulation of the business of insurance which has been another bedrock of NALU policy for many years.

Especially since the new statute is very bare-boned in nature, little guidance is offered to regulators on new jurisdictional and regulatory questions. Considerations such as whether the depositor's money will be subject to the risk of the insurance venture or whether insurance policy holders will be subject to the risks associated with bank lending experience are among the important points needing clarification. This will, no doubt, require examination of the effect on FDIC insurance and on state insurance solvency funds. Questions regarding proper licensing of any such combined insurance-bank entity to conduct insurance operations in states other than South Dakota are also wide open and ripe with controversy.

Apparently the South Dakota legislation was designed as part of a state jobs bill. But the fatal flaw in this jobs bill argument is that it will work only so long as other states refrain from liberalizing their own laws. In other words, no new jobs are ultimately created in the nation's economy by this kind of legislation. Jobs are simply shifted from state to state dictated by the willingness of any given state to hurriedly install bare minimum regulations. When you apply this phenomenon to the insurance business, insurance agents call this replacement. Just like life insurance replacement, we regard it as very rarely in the long term best interests of the public.

MR. HUGHES: I would like to give you the position of the life insurance companies, which is much the same as that of the agents. We are relative newcomers to the situation. The agents have been fighting the incursion of banks into their business for years. We have been standing by, probably due to some insurance companies having existing arrangements with banks to sell their products. As the whole deregulation procedure sped up, we reached the formal position of opposing generally the marriage of banking and insurance. *More specifically, our policy is against any deviation from the* status quo. One thing that we have focused on is the fundamental inconsistency between deregulating banks and the bank regulatory system. For example, if a bank can get into the insurance business, it is now involved in risk management. Implicit in the grant of authority to make profit is the grant of authority to lose money and ultimately to fail. That is the free market system. When we talk about deregulation, that is what we should be talking about.

The bank regulatory system, however, is set to up maintain the solvency of the depository institutions. You have the FDIC and FSLIC backing up the institution with insurance should management not be doing its job properly. You have the Fed standing as the lender of last resort. As a troubled institution continues to lose, the Fed will continue to keep it propped up until it comes to the point where it feels that it no longer can. Then it perhaps will negotiate a pampered merger of the troubled institution with a healthier institution. That is proper, that is how the integrity of the banking system should be maintained. But that is fundamentally inconsistent with letting the same institution into a free market environment without a dramatic rethinking of how you regulate that institution.

Despite the best efforts of banking and insurance regulators, there are insolvencies. What happens if you let a bank insured by the FDIC run an insurance operation as a department of that bank as is now permitted in South Dakota? You have a situation where the FDIC is not only insuring against unsound banking practices, but it is insuring against unsound insurance practices. If that insurance department turns out to be a loser, it can drag the whole bank down. The converse is obviously true. If the bank is not successful, the insurance department is going to go down. You might have state insurance guarantee associations, to the extent they exist, now having to insure against unsound banking practices. That is not why these guarantee funds were set up. The FDIC and FSLIC were not set up to insure against non-banking risks. That is the scenario that South Dakota legislation creates. That is the scenario that bank deregulation creates. That is one of the fundamental concerns of the life insurance companies. Jack, perhaps you want to speak to that.

MR. KALCHBRENNER: I will make more general public policy comments. I share the concern that if banks were permitted to get into a number of other risk-exposing activities, there would be a clear danger to the payments mechanism, the solvency of the financial system.

Proposals similar to last year's Treasury proposal are a step in the right direction. The only way that banks should become involved with the real risks of insurance is via some tight walls between the bank and insurance company subsidiaries of a holding company. I know that there are some problems of guaranteeing corporate separateness. There have been similar problems with real estate investment trusts. But, it would be possible through the holding company mechanism to guarantee that the monetary system could be controlled by the Fed, FSLIC, the Comptroller of the Currency or some other combination. The other activities could be regulated by the insurance departments or by the markets with respect to the capital adequacy. That is the position that I would take. But, I am uncomfortable with saying that banks can take on those additional risks, especially given the leverage factor of the banking industry of 20 to 1 or 5% capital positions, in an environment where they are already stretched to use that capital for other purposes.

MR. KERLEY: Agents do not concern themselves with solvency as much as they like to think they do. They think in terms of competition, or more appropriately, unfair competition. They do not believe that you can sufficiently wall off a bank subsidiary. From a theoretical standpoint, I

suppose it is possible. We as an agents' group sit around and think that perhaps we can compromise with the bankers. But we don't see any way to do that even though theory may say that you can do it.

It doesn't seem to be possible because of the subtle kind of tie-in that banks can bring to a loan situation. I am reminded of the many times as a banker that I looked at the financial statement of a small business seeking a line of credit. Every time we looked at the life insurance coverage of the one or two people who are the driving force behind the company, and we considered how safe its line of credit would be if the principal or principals behind that company were gone. In those cases where it seemed to us as bank lenders that there was inadequate insurance to carry that organization forward, we made the loan contingent on the acquisition of insurance. We did not provide the insurance, but we made it understood that it was part of the lending process. And in many cases the bank manager or lending officer would refer them to a friend or a board member in the insurance business. The credit applicant could not get over to the insurance office fast enough. That is the kind of visceral reaction that we are concerned about, no matter how much the regulatory or statutory framework would try to avoid it. That is why we are recalcitrant on this issue. We do not believe that you can separate banking and insurance unless you affirmatively separate them.

MR. BOOTH: Mike, when you are talking about deregulation, it is a two way street. Recently, there was talk about Prudental buying a bank. Would this not generate extra business for Prudential agents and would they not they like it?

MR. KERLEY: So far the reaction is that they do not like this. That is what they are telling their agents' association, although I am not sure that they are telling the home office.

If a big insurance company buys a little bank will it help the insurance company as opposed to a bank that buys an insurance company? Our opinion is that you can sell a lot of insurance through a little bank but you do not necessarily sell a lot of banking services through an insurance company. If Prudential bought a bank, I presume that there would be a scramble for other companies to buy a bank.

I do not know how it would affect the agency force. The reason is that I presume, even though it is now illegal, that the bank that Prudential would buy would exert the same kind of subtle pressure to tie the granting of credit with the purchase of insurance that we fear other banks would do. You do not need an agent to sell like that. You only need an agent if there is a free market, not if you eliminate the need for sales techniques. You can sell not only personal insurance but employee benefits or other insurance to small and middle sized companies. The General Electrics of this world do not need banks or insurance agents to help them develop their employee benefit programs. Our agents are in the small to medium business market of employee benefit programs and key man insurance. That is a market that a regional bank could devastate, from our standpoint, if they were in the insurance business.

MR. KALCHBRENNER: I would like to make one other comment. A recent report from the Federal Reserve Bank of Minneapolis discussed the proper business of banking. It is a new set of thinking in the Federal Reserve System to redefine what it is they are regulating. If it turns out that they redefine it by function rather than by institution, we could wind up with certain parts of insurance companies or brokers subject to controls by monetary authorities.

MR. BOOTH: Gary, in light of Vice President Bush's task force on regulation and the current state of uncertainty, what do you think of the future of state regulation? Will there be a super financial regulatory agency at the federal level?

MR. HUGHES: Some companies may be reconsidering the possibility of a federal charter. A federal charter could supersede some, but not all, state laws. This may become politically more realistic if financial service integration continues.

As far as the Bush task force, I think that one of their areas is to look at the consolidation or reorganization of bank regulatory functions. We were dismayed by the lack of representation of state insurance regulation on the task force. We have recently filed a letter with that task force cautioning them not to draw conclusions or recommend any legislation on the insurance business or the relative competitive portions of the insurance business due to the lack of insurance expertise on that task force. The National Association of Insurance Commissioners at their recent meeting in Baltimore passed a resolution strongly opposing the integration of banking and insurance.

MR. BOOTH: Jack, are we seeing a merging of lending and capital markets? What strategies are they employing?

MR. KALCHBRENNER: To oversimplify, insurance companies used to have long term cash flows and were out in the 20 to 30 year maturity range while banks were in very close with respect to commercial lenders. With the change in Federal Reserve policies and volatility of interest rates since 1979, all banks have changed their asset and liability practices. From what I understand from insurance company investment people, long term now means 8 to 10 years not 20 to 30 years.

Due to insurance products with variable rate features, the insurance companies have the portfolio management concerns that banking operations are involved in. Insurance companies are coming in shorter. With deregulation in the depository end of the market, banks can issue products that would permit us to match over longer periods of time. We could match up 5 to 10 year depository issues with term lending or some kind of leasing arrangement in a more stable environment. These trends could lead to some overlapping between banks and insurance companies in the capital market once the interest rate situation settles down somewhat.